Mississippi College Law Review

Volume 8
Issue 2 *Vol. 8 Iss. 2*

Article 10

1988

# Oil and Gas Law - Federal Law Preempts State Attempts to Impose Ratable-Take Order Regulation on the Purchasing of Gas by Pipeline Companies - Transcontinental Gas Pipeline Corp. v. State Oil and Gas Board of Mississippi

Leslie Elizabeth Idom

Follow this and additional works at: https://dc.law.mc.edu/lawreview

Part of the Law Commons

Custom Citation
8 Miss. C. L. Rev. 291 (1987-1988)

This Case Note is brought to you for free and open access by MC Law Digital Commons. It has been accepted for inclusion in Mississippi College Law Review by an authorized editor of MC Law Digital Commons. For more information, please contact walter@mc.edu.

# Oil and Gas Law — Federal Law Preempts State Attempts to Impose Ratable-Take Order Regulation on the Purchasing of Gas by Pipeline Companies

*Transcontinental Gas Pipeline Corp. v. State Oil and Gas Board of Mississippi,* 474 U.S. 409 (1986).

Table of Contents


I. Introduction .......... 291
II. Fact Summary .......... 292
III. Background and History .......... 296
A. The Natural Gas Act and its Dire Consequences .......... 297
B. The Natural Gas Policy Act - The Hands-Off Method .......... 298
C. *Northern Natural* — Preemption Under the NGA .......... 299
IV. The Opinions in Transcontinental .......... 300
A. The Majority .......... 300
B. The Dissent .......... 301
V. Analysis .......... 302
A. The Collision of the *Northern Natural* Ratable-Take Order and the Goals of the NGA .......... 302
B. The Conflict Between the *Transcontinental* Ratable-Take Order and the NGPA's Regulatory Scheme .......... 304
C. The States' Interest .......... 305
D. States Are Left With the Alternative of Production Regulation .......... 306
V. Conclusion .......... 307


## I. Introduction

In 1986 the United States Supreme Court handed down its decision in *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi.*[1] The Court held that federal law preempted a Mississippi Oil and Gas Board order which would have required Transco, an interstate pipeline, to take gas ratably[2] from all producers in the Harper Sand, a common source of supply in southern Mississippi, regardless of whether Transcontinental had contracts with these producers. The decision continues to have a strong impact on the natural gas industry. The states have a substantial interest in protecting the cor-

1. 474 U.S. 409 (1986).
2. "Ratably" means in proportion to all the owners' interests in the gas well. 474 U.S. at 409.

relative rights of co-owners in a common source of supply from waste and drainage. Yet, the *Transcontinental* decision foreclosed the states from regulating gas purchasing, even though several categories of natural gas were deregulated through the Natural Gas Policy Act of 1978 and presumably removed from federal control.

This note will examine the *Transcontinental* decision and its impact on state regulation of the natural gas industry. The federal regulatory schemes that have existed in the United States since the 1930's will be analyzed in turn. The goals and policies underlying these regulatory arrangements will also be discussed, and decisions thereunder will be scrutinized for congruency with these federal policies.

Finally, a survey of the states' alternatives in the wake of *Transcontinental* will be undertaken. All regulatory alternatives for the states necessarily lie in the area of production regulation. The states have strong interest in safeguarding correlative rights of co-owners in a common source of supply, and it seems the *Transcontinental* decision has indeed left them in an unfavorable position.

## II. Fact Summary

Getty Oil Company (Getty) and Coastal Exploration (Coastal) held production shares[3] in several natural gas wells producing out of a common pool[4] known as the Harper Sand.[5] The Harper Sand gas pool underlies portions of two adjacent fields[6] in southern Mississippi.[7] In 1982 there were at least six wells producing out of the Harper Sand,[8] which is at a depth of better than 15,000 feet.[9] While there were interest holders of diverse magnitudes in these wells,[10] Getty held a large percentage of the production shares in the three wells involved.[11]

3. A producer is one who owns "all or part interest in a well . . . capable of producing natural gas." Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd., 457 So. 2d 1298, 1305 n.1 (Miss. 1984). *See also* Miss. Code Ann. § 53-1-3(h) (1972). An operator is one who is authorized to take charge of the development of a producing well. 457 So. 2d at 1305 n.2. Getty was both the operator and a producer in several of the wells here involved. Coastal owned small undivided working interests in several of these wells. *Id.* at 1308.

4. A pool is "an underground reservoir containing a common accumulation of oil or gas or both." 457 So. 2d at 1307 n.4. *See also* Miss. Code Ann. § 53-1-3(e) (1972).

5. 457 So. 2d at 1307.

6. *Id.* A field is defined as "the general area which is underlaid by at least one pool; . . . [including] the underground . . . reservoirs containing oil or gas or both." *Id.* at n.3. *See also* Miss. Code Ann. § 53-1-3(f) (Supp. 1987).

7. The fields, known as the Greens Creek Field and the East Morgantown Field, were separate natural gas fields as defined by the State Oil and Gas Board in 1980. 457 So. 2d at 1307.

8. *Id.* Three of these wells were operated by Getty. The remaining three Harper Sand wells were operated by companies not parties to the *Transcontinental* case.

9. *Id.* *See infra* note 48 and accompanying text.

10. 457 So. 2d at 1305.

11. *Id.* at 1308.

In 1980 Getty entered into a long-term contract[12] with Transcontinental Gas Pipe Line Corporation (Transco), an interstate pipeline company,[13] for the purchase of gas.[14]

Until 1982, as was customary,[15] Coastal, like other small interest owners, had allowed Getty to arrange for the sale of its portion of the gas produced to Transco, even though Coastal and Transco had no contract between them.[16] These sales were generally for the same price and on the same terms as the contracts with Getty, the signatory seller.[17] However, in 1982, as a result of an industry-wide glut, the price of and the demand for natural gas plummeted, and Transco began invoking the "market-out"[18] provisions contained in some of the company's contracts.[19] Transco also announced that it would no longer purchase gas from those with whom it had no contract.[20] Coastal sought to ratify Getty's contract, and Transco counter-offered with a contract containing a lower purchase price[21] than that in the Getty contracts in addition to a "market-out" provision.[22]

Coastal refused this counter-offer and Transco ceased purchasing Coastal's gas.[23] It should be noted, however, that fifty-five other small interest owners accepted this offer from Transco.[24] Subsequently, Getty cut back production

---

12. As is typical in the natural gas industry, this contract contained a "take-or-pay" clause, which requires the pipeline purchaser to take delivery on an allotted percentage of the gas well's production capability or pay the contract price for the gas and postpone delivery until a later date. Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi, 474 U.S. 409, 412 (1986). For a general discussion of take-or-pay clauses, *see* Pierce, *Natural Gas Regulation, Deregulation and Contracts*, 68 VA. L. REV. 63, 77-79 (1982).

13. Transco had been contracting with producers in the East Morgantown and Greens Creek Fields for the purchase of natural gas since 1978. By 1982 Transco was committed to a total of thirty-five long-term contracts in these two fields alone. 457 So. 2d at 1307-08.

14. The contract price for the gas was $7.907 per thousand cubic feet (mcf). Contract prices for gas produced from the other Harper Sand wells ranged from $5.00 mcf to $9.054 mcf, depending upon market conditions at the time the contracts were entered into. 457 So. 2d at 1308.

15. *Id.* at 1309. Getty, as the operator, had the right but not the obligation to sell Coastal's and the other smaller owners' shares of the gas under the operating agreement. *Id.* at 1309 n.6. For a discussion of the operator's duties and the co-owner's rights under the operating agreement, *see* Smith, *Gas Marketing by Co-owners: Disproportionate Sales, Gas Imbalances and Lessors' Claims to Royalty*, 39 BAYLOR L. REV. 365 (1987).

16. 457 So. 2d at 1309.

17. *Id.* at 1308.

18. "Market-out" provisions allow the pipeline company to adjust the gas purchase price downward if economic conditions become unfavorable. *Id.* at 1309.

19. *Id.* Transco began paying those sellers $5.00 mcf pursuant to the "market-out" provisions in the contracts. *But cf. id.* at 1323. (Justice Robertson's view that Transco would not have been in court had it negotiated a "market-out" provision in its contract with Getty).

20. *Id.* at 1309.

21. The proposed purchase price was $5.00 mcf, the then-current market value of high-cost gas. *Id.* at 1310.

22. *Id.* at 1309. *See supra* note 18.

23. 457 So. 2d at 1309. Coastal was unable to find another purchaser for its gas, even though another pipeline, Tennessee Gas Pipe Line Co., also serviced these wells. *Id.* at 1310-11.

24. *Id.* at 1309.

of these wells to allow only an amount which would satisfy its own interests to be produced.[25]

At this point the phenomenon of drainage[26] should be interjected and explained. It is a commonplace occurrence and one which has been the subject of considerable litigation.[27] Under the principle of the Rule of Capture, the owner of mineral rights that correspond to a tract of land that he owns has the right to produce as much oil and gas as he can from a well on his property. The Rule of Capture can sometimes provide an incentive for overproduction and waste.[28] When more than one well produces out of a common source or pool, the potential for production imbalances and drainage arises. The gas below the ground is under pressure, and when it is extracted through drilling processes, the pressure at the point of extraction is decreased. The migratory nature of the hydrocarbon is such that the gas will then flow to the area of least pressure or resistance. The cumulative effect deprives other wells producing from the common pool of their share of the gas because their gas has migrated from their property to that of another.[29] Another unpleasant side effect of the drainage problem is that any gas remaining under the deprived owner's tract will sometimes be more difficult to extract because of this decrease in pressure.[30]

Since there were at least six wells producing out of the Harper Sand, the imbalance in production and gas sales stemming from the above-mentioned events triggered drainage problems. The effect of Transco's refusal to purchase Coastal's gas and of Getty's subsequent cutback of production was to deprive Coastal of its share of the gas produced from the Harper Sand. In light of the recognized drainage problem, this deprivation could be permanent.[31]

Coastal sought relief from the State Oil and Gas Board of Mississippi (Board).[32] One of the Board's duties is to create and enforce rules against abuse of the correlative rights[33] of each owner of oil and gas in a common source of supply.[34] Coastal filed a petition with the Board on July 29, 1982, requesting that

---

25. *Id.* at 1310.

26. *Id.* at 1306. *See also* Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd., 474 U.S. 409, 413 (1986). *See generally* Martin, *The Establishment of Allowables for Production of Gas in Louisiana*, 57 U. COLO. L. REV. 267, 267-69 (1986) (discussion of the phenomenon of drainage).

27. Northern Natural Gas Co. v. State Corp. Comm'n, 188 Kan. 355, 358, 362 P.2d 599, 602 (1961) (Kansas Supreme Court took judicial notice of drainage and its effects); Shell Oil Co. v. James, 257 So. 2d 488, 494-95 (Miss. 1971) (Mississippi Supreme Court defined drainage).

28. For a discussion of the Rule of Capture, *see* Martin, *The Establishment of Allowables for Production of Gas in Louisiana*, 57 U. COLO. L. REV. 267, 267-68 (1986).

29. 457 So. 2d at 1306-07.

30. *Id.* at 1310; Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd. 474 U.S. 409, 413 (1986).

31. 457 So. 2d at 1310.

32. *Id.* at 1311. The Board is an administrative agency created by the State of Mississippi. MISS. CODE ANN. § 53-1-5 (1972). *See also* 457 So. 2d at 1325-27.

33. Correlative rights protect every owner in a common source of supply of oil and gas by assuring his fair chance to reap the economic benefits resulting from obtaining his just and equitable share of production therefrom. *See* MISS. CODE ANN. § 53-1-1 (1972).

34. *See* MISS. CODE ANN. § 53-1-17(c)(13) (Supp. 1987).

Transco be required to take gas "ratably"[35] from all the owners within the common source pool, and to purchase without discrimination in favor of Getty against Coastal.[36] Coastal was, in effect, endeavoring to persuade the Board to force Transco to comply with Statewide Rule 48, a rule promulgated by the Board in November, 1951.[37] Statewide Rule 48 was drafted to combat the inequities produced by drainage and provides that a purchaser of oil or gas must "purchase without discrimination in favor of one owner . . . against another in the same common source of supply."[38]

In mid-October of 1982, the Board ruled in favor of Coastal and issued Order No. 409-82, which required Transco to comply with Statewide Rule 48 and to take and purchase[39] gas ratably from all owners in the Harper Sand pool, if it chose to take any gas at all.[40]

Transco appealed the Board's order to the Circuit Court of the First Judicial District, Hinds County, Mississippi.[41] On June 28, 1983, the court affirmed Order No. 409-82, and Transco subsequently took an appeal to the Supreme Court of Mississippi.[42]

Before the supreme court, Transco contended that Mississippi's authority to make and enforce Statewide Rule 48 was preempted by federal law, either by virtue of the commerce clause,[43] or through the supremacy clause[44] via the Natural Gas Act[45] (NGA) or the Natural Gas Policy Act of 1978 (NGPA).[46]

The Mississippi Supreme Court acknowledged that the state's authority to enforce Statewide Rule 48 would have been preempted prior to the enactment of the NGPA.[47] The court held that since the gas produced from the Harper Sand pool was high-cost natural gas,[48] a category deregulated by the NGPA,[49] the NGA, as modified by the NGPA, and the Federal Energy Regulatory Commission's (FERC) jurisdiction thereunder did not apply to the case before it.[50] The

35. *See supra* note 2.

36. 457 So. 2d at 1311.

37. *Id.* at 1311. Rule 48 had never before been employed to obtain relief for drainage loss as against a purchaser of natural gas. *Id.* at 1306.

38. Statewide Rule 48, Mississippi Oil and Gas Board Rules (1952).

39. *See infra* note 59 and accompanying text.

40. 457 So. 2d at 1311. (quoting Order No. 409-82, State Oil and Gas Board of Mississippi, October 13, 1982).

41. *Id.*

42. *Id.* at 1312.

43. U.S. CONST. art. I, § 8, cl. 3.

44. U.S. CONST. art. VI, § 2.

45. Natural Gas Act, 15 U.S.C. §§ 717-717z (1982).

46. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3342 (1982).

47. Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd., 457 So. 2d 1298, 1314 (Miss. 1984). *See generally* Arkansas Electric Coop. Corp. v. Arkansas Pub. Serv. Comm'n, 461 U.S. 375, 383-84 (1983) (federal decision to forego regulation may have as much preemptive force as decision to regulate); Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta, 458 U.S. 141 (1982) (fundamentals of federal preemption of state regulations); Jones v. Rath Packing Co., 430 U.S. 519, 525-26 (1977) (same).

48. 15 U.S.C. § 3317(c)(1).

49. *See infra* notes 82-90 and accompanying text (other categories of gas affected by the NGPA).

50. 457 So. 2d at 1316.

court decided the preemption issue in favor of the Board and against Transco.[51]

Transco also advanced the theory that the enforcement of Order No. 409-82 was unconstitutional, "because it create[d] an impermissible burden on interstate commerce."[52] The court rejected this contention, employing the balancing test set forth in *Pike v. Bruce Church, Inc.*,[53] which involved a balancing of the legitimate local public interest advanced by the challenged law, rule, etc., and the burden on interstate commerce.[54] The court held that the legitimate local interests of conservation and protection of correlative rights advanced by Statewide Rule 48 and Order No. 409-82 outweighed the incidental effect on interstate commerce.[55]

Transco had several other claims before the Mississippi Supreme Court. Among these were a void-for-vagueness contention[56] and a taking without compensation claim.[57] The court rejected these claims summarily,[58] but reversed the part of Order No. 409-82 which could possibly have been construed to require Transco to purchase without discrimination in price against one owner in favor of another.[59] In the other respects, the judgment of the circuit court was affirmed.[60]

Transco finally appealed the Board's order No. 409-82 to the United States Supreme Court. "[B]ecause of the importance of the issues in the functioning of the interstate market in natural gas,"[61] the Court noted probable jurisdiction.[62]

## III. BACKGROUND AND HISTORY

The decision in *Transcontinental Pipe Line v. State Oil and Gas Bd.*[63] (*Transcontinental*) was influenced by the Natural Gas Act[64] (NGA) and the Natural Gas Policy Act of 1978[65] (NGPA), as well as judicial decisions construing these statutes. To evaluate the holding in *Transcontinental*, it is necessary to understand the mechanisms of the natural gas industry, Congress' purpose in regulating

51. *Id.* at 1318.
52. *Id.*
53. 397 U.S. 137 (1970).
54. *Id.* at 142.
55. 457 So. 2d at 1321-23.
56. *Id.* at 1323-24.
57. *Id.* at 1324-25.
58. *Id.* at 1323-25.
59. *Id.* at 1331. The Mississippi Supreme Court found that the Board had no authority to engage in price regulation and that Rule 48 should be construed so as to prohibit discrimination with respect to quantity, not price. *Id.* at 1330. The court qualified this holding by requiring that a pipeline, in order to comply with Rule 48, must offer in good faith, a reasonable price in keeping with prevailing market conditions. *Id.* at 1331. *Cf.* note 19 and accompanying text.
60. *Id.* at 1332.
61. Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd., 474 U.S. 409, 411 (1986).
62. Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Bd., 470 U.S. at 1083 (1985).
63. 474 U.S. 409 (1986).
64. 15 U.S.C. §§ 717-717z (1982).
65. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1982).

it, and the Court's interpretation of the Congressional mandates when controversies have arisen.

*A. The Natural Gas Act and its Dire Consequences*

In 1938, President Roosevelt signed into law the Natural Gas Act, which had been designed to give the federal government control over the interstate sales and transportation of natural gas.[66] The aim of the NGA was to deter the monopolistic practices of interstate pipeline companies by suppressing the price at which producers sold gas to them,[67] thus protecting the public as well as the industry.[68]

The Federal Power Commission (FPC) was given the task of administering the NGA. The FPC was to set reasonable cost-based price ceilings for the sale of natural gas in the interstate market,[69] thus ensuring consumer protection among the competing interests. These ceilings were to be determined by considering the actual cost of the gas plus a reasonable rate of return with an allowance for depreciation.[70]

The FPC at first used an individual cost-of-service method in arriving at its price ceilings.[71] Thus, each producer of gas was given individual attention in the determination of its ceiling. This soon proved to be an impractical method, and as the backlog of cases mounted into the thousands, the FPC searched for a better way to fix price ceilings.[72]

In 1960, the FPC began implementing area-rate methods in its determination of price ceilings.[73] The FPC divided the nation into five regions, and embarked on extensive studies to determine a reasonable ceiling for each area.[74] The studies were so intensive and the conditions of the industry so dynamic that by the time the ceilings were affixed, they had already become antiquated.[75] The result of these obsolete ceilings was the gas shortage of the early 1970's, when the problem was serious enough to warrant rationing.[76] However, it was during this period

---

66. Pierce, *Natural Gas Regulation, Deregulation, and Contracts*, 68 VA. L. REV. 63, 65 (1982).

67. Pierce, *supra* note 66 at 65. *See also* Federal Power Comm'n v. Louisiana Power & Light Co., 406 U.S. 621 (1972); Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

68. Breyer and MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 941 (1973).

69. Permian Basin Area Rate Cases, 390 U.S. 747, 754-55 (1968).

70. Note, *Legislative History of the Natural Gas Policy Act*, 59 TEX. L. REV. 101, 107 (1980). *See also* Permian Basin Area Rate Cases, 390 U.S. 747, 756 (1968).

71. Note, *Legislative History of the Natural Gas Policy Act*, 59 TEX. L. REV. 101, 107 (1980).

72. 390 U.S. 747 at 756-58.

73. 390 U.S. at 758.

74. Pierce, *supra* note 66 at 67 n.16.

75. *Id.* at 67.

76. *Id.* at 67-68. The shortage was the result of the industry's failure to meet market demand and the subsequent decline of gas reserves. The effects on the consumer ranged from lay-offs in gas-related industries to deaths caused by lack of heat. *Id.* at 67-68 n.18. *See also* Breyer and MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 976-79 (1973).

of area-rate regulation that the FPC first adopted a dual price system distinguishing between "old gas" and "new gas." The theory was that "old gas" or gas flowing from existing wells, would have production costs that were constant, since the major expense of discovery and drilling had already been incurred.[77] Therefore, gas from these wells would have lower price ceilings than "new gas," which would come from wells not yet drilled. The purpose of this system was also two-fold: to encourage the development of new wells and to prevent sellers of "old gas" from incurring a windfall at the consumer's expense.[78]

In response to the shortages, the FPC, in 1974, adopted a "national-rate" approach in which it considered future cost projections when setting the price ceilings for "new gas."[79] Consequently, the ceilings rose significantly, but the shortages persisted.

By the late 1970's, it was apparent that there were many problems with the NGA. Regulation under the NGA had caused natural gas shortages: supply was low, yet demand was high. Since the intrastate market was free of regulation, the prices were higher and much of the exploration and new drilling operations were being directed there.[80]

*B. The Natural Gas Policy Act of 1978 - The Hands-Off Method*

In response to these problems, Congress enacted the NGPA. In passing this, Congress sought to protect consumers by ensuring a continuous supply of natural gas as well as by keeping prices low.[81] The NGPA increased the scope of federal regulation to include the sale of all natural gas, whether interstate or intrastate.[82] The purpose of this expansion of scope was to provide uniformity in the industry, thus discouraging preference of one market over another.[83] Incentive pricing was used to spur exploration in order to ensure supplies.[84] The old price controls on existing gas were preserved to prevent an increase in consumer prices.[85] The price ceiling system was changed from a double-tiered to a multi-tiered one, but it retained the same purposes and objectives.[86] The three main categories were:

1) High-cost natural gas or gas produced from great depths.[87] Briefly,

77. Pierce, *supra* note 66 at 67-68.
78. *Id.* at 68-69.
79. Note, *Legislative History of the Natural Gas Policy Act*, 59 TEX. L. REV. 101, 110 (1980).
80. *Id.* at 112.
81. Breyer and MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 943 (1973).
82. Note, *supra* note 79, at 120-21.
83. *See* 15 U.S.C. §§ 3315(b)(3)(A) & (D), 3316(b) (1982).
84. Note, *supra* note 79, at 112.
85. Note, *supra* note 79, at 116. *See* 15 U.S.C. §§ 3312-3313, 3317-3318, 3320 (1982) (the incentive price sections).
86. *Id.*
87. 15 U.S.C. § 3317(c) (1982).

the Harper Sand gas in *Transcontinental* fell within this category. High-cost gas accounts for only a small portion (less than 10%) of the total of gas sold, and in 1979, to encourage development and exploration, this category of gas was deregulated.

2) New gas from new wells.[88] Under the NGPA, this category was still subject to price ceilings and was to become deregulated in the future.

3) Old gas from existing wells.[89] This type of natural gas would continue to keep the same price ceilings as before, increasing only at the rate of inflation.[90]

The scheme summarized above represents a gradual deregulation of the sales of natural gas, with the ultimate goal being low consumer prices resulting from a more balanced market.

Though the NGA proved too restrictive on the natural gas industry, the NGPA did not represent a desire of Congress to completely abandon oversight of the sales of natural gas. The lower court in *Transcontinental,* however, apparently viewed the NGPA as such a Congressional abandonment.

*C. Northern Natural - Preemption Under the NGA*

In 1963, in the wake of the area-rate pricing confusion, the Supreme Court decided *Northern Natural Gas Co. v. State Corp. Comm'n.*[91] The issue before the Court in that case was, for all practical purposes, identical to the controversy in *Transcontinental,* that being whether the oil and gas administrative board (The State Corporation Commission) could order an interstate pipeline company (Northern Natural Gas Company) to purchase gas ratably from all owners in a common source.[92] The Court invalidated this order, holding that it invaded the jurisdiction vested in the FPC by the NGA.[93]

The Kansas Supreme Court had upheld the order, ruling that it was applicable to the "production and gathering" of natural gas and therefore exempted from the jurisdiction of the FPC by virtue of 15 U.S.C. § 717(b)(1)(b).[94] The Court rejected this holding, stating that production and gathering were terms narrowly to be defined to include the extraction of oil and gas from the earth and the preparation for the first stages of distribution only.[95] Even if the order was imposed as a conservation measure, the Court concluded that if it interfered with the NGA's purpose of uniformity, whether directly or indirectly,

88. 15 U.S.C. §§ 3312-3313 (1982).
89. *See* 15 U.S.C. §§ 3314-3316, 3318-3319 (1982).
90. Pierce, *supra* note 66, at 88-89.
91. 372 U.S. 84 (1963).
92. *Id.* at 85-86.
93. *See supra* note 105 and accompanying text.
94. 372 U.S. at 89.
95. *Id.* at 90.

it could not stand.[96] The order would result in a readjustment of purchase patterns and consequently would jeopardize the balance between cost structures and consumer costs which was the very essence of the FPC's jurisdiction.[97] Therefore, the Court reasoned, the state's regulatory authority must be subordinated to that of the federal government. The order was thus struck down.

However, a state conservation measure was approved in *Champlin Refining Co. v. Corporation Comm'n*,[98] where the Court sustained a state order requiring ratable production. The order had been made in the interests of conservation, and the Court stated that since it applied to production which was intrastate in nature and not to the sale or transportation of hydrocarbons, it was not threatening to federal regulation, and could stand.[99]

In light of the foregoing statutes and cases, it is evident that Congress has been concerned for a great part of this century with the task of ensuring adequate supplies of natural gas to the consumers at a favorable price. The courts, on the other hand, have been faced with the formidable duty of striking a balance between the states' interests in conservation of its natural resources, the interests of Congress in natural resources, and Congress' authority to regulate the natural gas industry.

## IV. The Transcontinental Opinions

### *A. The Majority*

In 1963, the Supreme Court had struck down a regulation similar to the Mississippi Board's order in *Northern Natural Gas Co. v. State Corp. Comm'n of Kansas* on federal preemption grounds.[100] The Court remarked that an application of the standard employed in *Northern Natural* would almost certainly produce the same result in the case at bar.[101] The issue to be decided was whether the enactment of the NGPA of 1978[102] varied the scheme of federal regulation enough to produce a result different from that in *Northern Natural*.[103] The Court stated that the rationale behind the decision in *Northern Natural* was the preservation of Congress' role in regulating the natural gas industry, as well as the ensurance of low prices, and consumer protection.[104] The Court discussed the purposes behind the NGA of 1938, which were to give the FPC[105] the power to regulate prices and to set price ceilings for gas sales from producers to pipe-

96. *Id.* at 91.
97. *Id.* at 92.
98. 286 U.S. 210 (1932).
99. *Id.* at 235.
100. 372 U.S. 84 (1963).
101. 474 U.S. at 417.
102. 15 U.S.C. §§ 3301-3342 (1982).
103. 474 U.S. 409, 417 (1986).
104. *Id.* at 420.
105. The Federal Power Commission (FPC) is the predecessor of the Federal Energy Regulatory Commission (FERC), which is the administrative authority of the NGPA.

lines.[106] In the early 1970's, it became apparent that these measures were not proving effective in combating the natural gas shortages and related problems, and the NGPA of 1978[107] was subsequently enacted in an attempt to rectify the situation.[108] The NGPA, the Court stressed, represented a new role for Congress, but did not signal a retreat from all jurisdiction over the sale of natural gas.[109] Coastal argued that the NGPA divested the FERC of jurisdiction over high-cost natural gas such as that produced out of the Harper Sand, thereby leaving the states free to regulate it.[110] The Court agreed that the FERC could no longer directly regulate the prices at which interstate pipelines purchased natural gas falling in the high-cost category, but said that Mississippi's action "directly undermine[d] Congress' determination that the supply, the demand, and the price of high-cost gas be determined by market forces."[111] The Court further stated that a divestment of jurisdiction of the FERC by Congress was not equivalent to a gift of that power to the states.[112] If this had been a goal of Congress, a determination in that respect would have been made explicitly.[113] The Court expressed displeasure with the Mississippi order for two other reasons. First, because the Order would force interstate pipelines to comply with varied state regulations, the uniformity of the federal scheme envisioned by Congress would be disrupted.[114] Second, the Court found that the ratable-take order would have as an ultimate effect increased prices to consumers.[115]

Because of these concerns and in the interest of federal preemption, the Court reversed the Mississippi court's decision.[116] However, the Court declined to reach a decision on the commerce clause question, since it had already reversed on the above-enumerated grounds.

*B. The Dissent*

In his dissent, Justice Rehnquist began by noting that "ratable-take" orders are a common solution to the common problem of drainage in the oil and gas industry.[117] He stated that the Harper Sand gas is no longer covered by the

106. 474 U.S. at 420.

107. 15 U.S.C. §§ 3301-3342 (1982).

108. 474 U.S. at 420. *See supra* notes 81-90 and accompanying text.

109. 474 U.S. at 421. For a discussion of the FERC's functions and duties since the enactment of the NGPA *see* Haase, *The Federal Role in Implementing the Natural Gas Policy Act of 1978*, 16 HOUS. L. REV. 1067 (1979).

110. 474 U.S. at 421.

111. *Id.* at 422.

112. *Id.* at 423.

113. *Id.* at 422. The states are explicitly given regulatory authority with respect to natural gas production, 15 U.S.C. § 3413(c), and the authority to establish ceiling prices, in 15 U.S.C. § 3432(a).

114. 474 U.S. at 423.

115. *Id.* For a general discussion, compare Williams, *Federal Preemption of State Conservation Laws After the Natural Gas Policy Act: A Preliminary Look*, 56 U. COLO. L. REV. 521, 532 (1985) (suggesting that any problem of increased consumer costs would be attributable to Transco's imprudent purchasing practices).

116. 474 U.S. at 425.

117. *Id.* at 425-26.

NGA, and that for this reason, *Northern Natural*[118] should not govern the ruling in this case.[119] Justice Rehnquist stated that the issue should have been whether the ratable-take rule was a stumbling-block to the full accomplishment of the NGPA's objectives, which were to eliminate governmental controls on the wellhead price of natural gas.[120] The dissent categorized the Board's order as a state regulation which defines property rights or establishes contract rules,[121] but which does not interfere with interstate commerce.[122] Instead, the dissent argued that these regulations served to promote the efficient functioning of the market.[123] Justice Rehnquist asserted that the ratable-take order would not affect prices in the spot market or in long-term contract settings.[124] The dissent further noted that Transco was in fact largely responsible for its own predicament, since it was charged with awareness of all state regulations when it undertook to conduct business in Mississippi.[125] The only reason the Board's order had an adverse effect on Transco, the dissent concluded, was that Transco had entered into long-term contracts with take-or-pay conditions.[126]

## V. ANALYSIS

The majority in *Transcontinental*[127] relied heavily on the reasoning in *Northern Natural.*[128] This was true even though the two decisions occurred under different congressional regulatory schemes: *Northern Natural* under the NGA,[129] and *Transcontinental* under the NGA as modified by the NGPA.[130]

### *A. The Collision of the Northern Natural Ratable-Take Order and the Goals of the NGA*

Congress enacted the NGA upon the determination that the natural gas industry was "affected with a public interest" in the distribution of natural gas to the public.[131] In light of this determination, federal regulation of natural gas sales and transportation was deemed "necessary in the public interest."[132] Pertinent cases have revealed a general consensus that the foremost goal of the NGA was consumer protection from high prices imposed by an exploitative

118. 372 U.S. 84 (1963).
119. 474 U.S. at 429.
120. *Id.* at 432.
121. *Id.* at 433-34.
122. *Id.* at 434.
123. *Id.*
124. *Id.* at 433.
125. *Id.* at 434-35.
126. *Id.* at 435. *See supra* note 12 for a definition of take-or-pay provisions.
127. 474 U.S. 409 (1986).
128. Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84 (1963).
129. Natural Gas Act, 15 U.S.C. §§ 717-717w (1982).
130. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3342 (1982).
131. 15 U.S.C. § 717(a) (1982).
132. *Id.*

natural gas industry.[133] Another concern reflected was the need to fill the regulatory "gap" resulting in the federal prohibition of state regulatory authority of interstate commerce activities.[134]

The court in *Northern Natural*, in deciding the preemption issue, recognized that the federal regulatory scheme embodied in the NGA was comprehensive and left no room for direct or indirect state regulation of natural gas prices.[135] Any state action upsetting the uniformity of regulation envisioned by the NGA was therefore invalid.[136] The balancing of the production or output of gas wells in the state was viewed as a task best left to that state's oil and gas commission, rather than to the interstate purchaser upon whose shoulders the burden would fall if ratable-take orders were upheld.[137] The *Northern Natural* Court also recognized the traditional state power of conservation and allocation of its natural resources; yet, the Court held that a state regulation which threatened to undermine the federal regulatory scheme could not stand, no matter the legitimacy of the premise under which it was promulgated.[138]

Under the NGA, then, ratable-take orders were prohibited by *Northern Natural* due to their indirect interference with the price of natural gas in the interstate market. Although the denouncement of any state regulation which affects prices seems overbroad, the decision in *Northern Natural* was congruent with the policies of consumer protection from exorbitant prices attributed to the NGA.

During the NGA's reign as the primary federal regulatory scheme in the natural gas industry, federal interest in pricing matters was arguably more pervasive than it is now under the NGPA. This is evidenced by the difference in the regulatory schemes, as well as by the degree of direct federal involvement in the industry. Under the NGA, price ceilings were determined by the FPC. This required intensive involvement of the FPC at all levels of pricing. The price ceilings imposed by the NGA in the name of consumer protection resulted in supply shortages, which ultimately proved to be detrimental to consumer interests.[139] With the advent of the NGPA of 1978, the scheme of federal regulation changed to one of gradual deregulation,[140] with market forces determining

---

133. *See* Federal Power Comm'n v. Louisiana Power & Light Co., 406 U.S. 621 (1972); Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

134. *See* Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944); *cf.* Williams, *Federal Preemption of State Conservation Laws After the Natural Gas Policy Act: A Preliminary Look*, 56 U. COLO. L. REV. 521, 524 (1985) (Suggestion that the purpose of natural gas regulation during the NGA era was "to transfer wealth from gas producers to consumers").

135. 372 U.S. at 91.

136. *Id.* at 94-95.

137. *Id.* at 92.

138. *Id.* at 93.

139. *See supra* note 76 and accompanying text.

140. *See supra* notes 81-90 and accompanying text.

the price of deregulated gas, and the FERC's duties in terms of pricing were curtailed significantly.

The aim of the NGPA is similar to that of the NGA: consumer protection. The NGPA's method of achieving that purpose, deregulation, also reveals the legislation's additional goal of providing a balanced, competitive market which will ensure adequate supplies to the consumer.

*B. The Conflict Between the Transcontinental Ratable-Take Order and the NGPA's Regulatory Scheme.*

*Transcontinental* was decided under the NGA as modified by the NGPA of 1978. The Court found that Congress, in enacting the NGPA, intended that the unnatural price manipulation practiced under the NGA be abandoned; therefore, the Mississippi Board's ratable-take order could not be upheld either, since its effect would be to artificially stimulate demand.[141]

The Court also determined that the FERC's oversight function of costs passed on to the consumer by the interstate pipeline established a pattern of continued federal occupation of the natural gas pricing field.[142] If the FERC finds the pipeline's purchasing costs "excessive due to fraud, abuse, or similar grounds,"[143] the pipeline must answer to the FERC and consequently will not be allowed to pass those excessive costs on to the consumer.[144] This continued federal involvement refutes any contention that the federal government relinquished all authority over the high-cost gas market under the NGPA.[145]

Transco's attempt to transmit purchasing costs of the Harper Sand gas to its customers had in fact been challenged in a FERC proceeding on grounds of abuse prior to the decision in *Transcontinental*.[146] The FERC wanted the Administrative Law Judge (ALJ) to order Transco to disregard Mississippi's Rule 48[147] and to pursue a less costly purchasing plan regarding the Harper Sand gas.[148] The judge refused to instruct Transco to disregard Rule 48, as it was Mississippi law, and held that the pipeline had to obey the ratable-take order as long as the order was in force.[149] As a result, the judge held that Transco's purchases were not imprudent in light of the ratable-take order.[150]

The Court considered the grounds of the ALJ's finding in the FERC proceeding illuminative of a conflict between the Mississippi order and federal regulatory

141. 474 U.S. at 424.
142. *Id.* at 423 n. 5.
143. 15 U.S.C. § 3431(c)(2) (1982).
144. 474 U.S. at 423.
145. *Id.*
146. Transcontinental Gas Pipe Line Corp. 33 F.E.R.C. ¶ 63,026 (1985).
147. *See supra* notes 37-38 and accompanying text.
148. 33 F.E.R.C. at ¶ 65,073.
149. *Id.* at ¶ 65,074.
150. 474 U.S. at 423 n. 5.

jurisdiction.[151] The Court's conclusion was that Mississippi's actions were preventing the FERC from exercising its oversight function over purchasing practices.[152] Had the ALJ held that the Mississippi order caused excessive purchasing costs, an inherent conflict between federal and state law would have been recognized. Under those circumstances preemption would have been warranted under the supremacy clause.[153] In light of the ALJ's ruling upholding the ratable-take order,[154] the Court reasoned that preemption was warranted anyway, since the Mississippi Board's ruling increased prices and thus subverted Congressional intent.[155]

The Court, in deciding that Congress did not intend for the states to occupy the regulatory position abandoned by the federal government upon deregulation, noted that the NGPA explicitly granted additional regulatory authority to the states.[156] Ratable-take orders, however, were not mentioned.[157] Several major oil and gas-producing states have issued similar regulatory orders.[158] Thus, Congress was certainly aware of the existence of such orders, and of the Court's ruling in *Northern Natural*, during the development of the NGPA. The allowance of these ratable-take orders would be counterproductive to the uniformity of the natural gas market envisioned by Congress.[159]

The *Transcontinental* decision seems to convey that a state can intervene in the regulatory arena of natural gas as long as its actions further the federal goals of low prices to the consumer and a market free of most restrictions on competition. Since the Mississippi order did affect natural gas price and demand, the Court's reasoning is understandable; however, the ruling leaves the states in a quandary. Most state regulations could conceivably affect market conditions in some way, thus infringing on the power attributed to the federal government by the *Transcontinental* decision. Yet, the states have a substantial and traditional interest at stake which bears regulation – the conservation of their natural resources.

### *C. The States' Interests*

The states' primary concerns in the conservation of oil and gas arise in the areas of waste prevention and protection of correlative rights. The states' problem

---

151. *Id.*

152. *Id.* U.S. CONST. art. VI, § 2. For a general discussion, compare Williams, *Federal Preemption of State Conservation Laws After the Natural Gas Policy Act: A Preliminary Look*, 56 U. COLO. L. REV. 521, 529-30 (1985) (Suggestion that the fraud and abuse oversight function of the FERC is to be exercised in a "hands-off" manner).

153. *See* Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 248 (1984).

154. Transcontinental Gas Pipe Line Corp., 33 F.E.R.C. ¶ 63,026 (1985).

155. 474 U.S. at 423.

156. *See supra* note 111.

157. *See* 474 U.S. at 423-24.

158. 372 U.S. 84, 101 n.3 (1963). (Justice Harlan dissenting).

159. 474 U.S. at 423.

lies in the fact that the unfettered exercise of the principle embodied in the Rule of Capture[160] can produce two undesirable offspring - waste and drainage.[161]

Waste can result if interest owners overproduce to keep from being drained themselves, while there is no market for the gas they produce. Surface storage of excess gas is generally not feasible,[162] and if the demand for gas is low, the producer's gas could be drained by other producers in the common source or pool who are able to market their gas. To combat these obvious inequities, states modify the Rule of Capture through various measures which further the doctrine of correlative rights.

The utility of ratable-take orders is apparent when the bargaining positions of the pipeline purchaser and the producer are examined. Also, the relative scarcity of pipelines places the gas producer at the mercy of the pipeline purchasers in some respects. Since natural gas by its very nature is economically transportable only by pipeline, it is important for a gas producer to have a pipeline nearby before he drills a well at a proposed location. It is even more important for the producer to be able to sell his gas to the neighboring pipeline once production begins. If he does not obtain a contract, he runs the risk of frustrating his market outlet and of having his own gas drained from beneath him, as was Coastal's plight in *Transcontinental.*[163] Ratable-take orders serve to provide a market outlet for the gas producer by requiring pipeline purchasers to take proportionately from all the interest owners in a common source of supply. Consequently, all owners are able to produce and market their fair share of gas, thus enjoying their complete property rights.[164] Since *Transcontinental* forecloses the use of ratable-take orders by the states, however, the alternatives necessarily lie in the area of production regulation.[165]

### *D. States Are Left With the Alternative of Production Regulation*

States may protect correlative rights and prevent waste and drainage through regulation of the production of natural gas.[166] One method of production regulation is prorationing, in which the state oil and gas commission determines the allowable or maximum amount to be produced from a reservoir during a certain period of time and allocates this total amount among the wells involved.

States may determine their allowables on the basis of market demand in order to protect correlative rights. When the market demand is low, allowables may

---

160. *See supra* note 28 and accompanying text.

161. *See supra* notes 26-30 and accompanying text.

162. For a discussion of the marketing conditions in the natural gas industry, see Martin, *The Establishment of Allowables for Production of Gas in Louisiana*, 57 U. COLO. L. REV. 267, 270-71 (1986).

163. Martin, *supra* note 162, at 270-73.

164. *See* 1A W. SUMMERS, OIL AND GAS § 103.1 (2d ed. Supp. 1987).

165. Champlin Ref. Co. v. Corp. Comm'n, 286 U.S. 210 (1932).

166. For a general discussion of prorationing, see McDonald, *Prorationing of Natural Gas Production: An Economic Analysis*, 57 U. COLO. L. REV. 153 (1986).

be reduced, and accordingly, when market demand is high, the allowables may be adjusted upwardly. The logic underlying this method is that when gas production is in excess of market demand, curtailing production will prevent pipeline purchasers from discriminating against producers in a common source or supply.

In Mississippi, however, prorationing on the basis of market demand is expressly prohibited by statute.[167] The method of setting allowables is on the basis of the pool or reservoir's maximum efficient rate of production, subject to the enforcement and protection of the correlative rights of the owners of a common source of oil and gas.[168]

Moreover, in an excellent article encompassing the subject, Professor Martin suggests reasons why the market demand method of determining allowables is impractical for natural gas.[169] Since the practice in the natural gas industry is to sell gas via the use of long-term contracts, adjustment of allowables to meet market demand could interfere with the expectations of the parties involved.[170]

If a take-or-pay clause[171] is involved in the long-term contract, the pipeline purchaser could conceivably be relieved of its obligation thereunder via a *force majeure*[172] defense.[173] This type of prorationing does not seem to be a viable answer to the correlative rights problem, since the pipeline purchaser is the only party relieved. The non-contract producer is still not assured that his gas will be sold even if allowables are reduced, since *Transcontinental* soundly refuted any possibility that the state could force the pipeline purchaser to take gas ratably from all producers involved.

## VI. Conclusion

A state such as Mississippi, in which the natural gas prorationing determination is not made with reference to market demand, must strive to develop an equitable method of setting allowables so that the correlative rights of co-owners in a common source of supply will be protected. In view of the concerns noted, this will prove to be a difficult task, and may result in much litigation, as determinations will have to be made on an individual basis.

In view of *Transcontinental*, it is clear that any course of action the several states may choose to protect correlative rights must necessarily be in the area

---

167. Miss. Code Ann. § 53-1-1 (1972).

168. *Id.*

169. Martin, *supra* note 162, at 282.

170. *Id.*

171. *See supra* note 12.

172. A *force majeure* is an unforeseen event beyond the parties' control the occurrence of which can be used as a defense to non-performance of a contract. *See generally* Annotation, Gas and Oil Lease Force Majeure Provisions: Construction and Effect, 46 A.L.R. 4th 976 (1986); 4 H. Williams, Oil and Gas Law § 733 (1986).

173. Martin, *supra* note 162, at 270-71.

of production regulation. Understanding that *Transcontinental* stands for the proposition that a state may not force pipeline purchasers to take ratably among the owners of a common source of supply, producers of natural gas should procure contracts with pipeline purchasers whenever possible. This state of affairs will continue to exist until Mississippi and similarly situated states adopt a viable method of production regulation.

*Leslie Elizabeth Idom*